

**A STUDY OF THE CONTENT AND ARRANGEMENT
OF THE INCOME STATEMENT**

BY

ROBERT KUHN MAUTZ

B.S., University of North Dakota, 1937

M.S., University of Illinois, 1938

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AN ABSTRACT OF A THESIS

**SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN
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A STUDY OF THE CONTENT AND ARRANGEMENT OF THE INCOME STATEMENT

Need for a study of income statement content and arrangement is indicated by three facts: (1) in recent years there has been an ever growing emphasis upon financial statements as a means of securing investor protection; (2) there has been an increasing tendency to view income statements as a major, if not the principal, financial statement for this purpose; (3) there has been considerable lack of agreement as to what constitutes the best income statement practice.

The importance of financial statements as a means of securing investor protection is illustrated by the work of the Securities and Exchange Commission which operates on the principle that provision of adequate information in itself provides an effective measure of protection to present and prospective interests. Financial statements are the accepted instruments whereby protective information is made available.

The shift in emphasis from balance sheet information to data concerned with operations, i.e., the income statement, reflects a change in methods of enterprise finance from bank credit to sale of capital stock. Stockholders are long-run capital interests concerned with earning power rather than with financial condition.

Income statement practice lacks substantial agreement on two main points: content and arrangement. Published income statements and professional literature alike indicate that no consensus exists regarding exactly what items of income and expense should be included and which excluded from periodic income statements. Neither is there general accord on the proper arrangement or organization of the material to be included.

Lack of a consensus upon income statement form and content grows out of the nature of accounting practice. A great number of accountants practicing over a long period

of time, holding different ideals of professional conduct, and subject to varying degrees of pressure from clients who have diverse interests, are almost certain to work out income statements varying considerably in form and content, even for similar concerns.

Mere codification of existing practice then cannot provide an acceptable solution to problems of income statement preparation. Such codification establishes the *status quo* as a standard. The very practice which created and now contains income statement problems is established as a goal. Little progress can be made toward an improved unified practice if existing procedure is established as its own criterion.

A different approach is used in this study, one supported by accounting theory rather than by accounting practice. It is based upon a careful analysis of the function of accounting, and the nature, purpose, focus, problems, characteristics, deficiencies, and social significance of financial statements in general. With this analysis as a background, deductive reasoning is employed to determine what income statement content and form should be in order that income statements may discharge fully their economic function.

NATURE OF FINANCIAL STATEMENTS

Accounting is a mechanism to provide various agencies with information about asset utilization, disposition, and status in a business enterprise in order that those agencies may function effectively to control that enterprise.

Financial statements are the specific device used by accounting to convey control information to management, to various investor interests, and to government. As a means of conveying information, financial statement are not without certain deficiencies resulting from the nature of the subject matter, weaknesses in accounting, and the failure of statement readers properly to appreciate statement limitations.

Management, because of its position at the helm of enter-

prise and because of its unique fiduciary relationship to the other interests in the enterprise, is charged with a high degree of responsibility not to abuse that position either in operating the enterprise or in reporting necessary information about enterprise operations to the other interests. Financial statements are thus primarily a facilitating device assisting in the exercise of various controls over business enterprise and secondarily an expression of the fiduciary relationship of management to the other interests in the enterprise. As such, financial statements must present adequate, factual information in an understandable form so that all enterprise control agencies can interpret and act upon it as they see fit.

Accounting and statistics are much alike in that both are tools of control, i. e., they are methods for collection, classification, summarization, and presentation of numerical data to other agencies which base judgments and action upon those data. Because the two fields are so similar in nature and in problems faced, various rules for treatment of numerical data in statistics are found to apply in accounting. However there are also differences between the two fields. The most important dissimilarity for the purpose of this study is the difference between statistical tables and financial statements.

As a general rule statistical tables are merely tabulated summaries or classified lists of data utilized to accompany and support such interpretive devices as mathematical analyses, graphs, charts, and textual comment. Financial statements likewise are tabulated summaries but because of the existence of important interrelations in the data which they present and because frequently no other interpretive devices are presented with them they have a responsibility to present their summarized data as intelligibly and helpfully as possible. Financial statements must be interpretive presentations as well as tabulated summaries if they are to discharge their function to the fullest. The additional fact that statistical tables can utilize both column heads and stub titles to assist in presenting classifications whereas fin-

ancial statements are restricted to side heads only adds somewhat to the difficulty of obtaining the interpretive presentation required in financial statements.

INCOME STATEMENT CONTENT

Broadly speaking, there are two general schools of thought on the subject of income statement content. One group views the income statement as a computation of normal periodic net income. Hence it would exclude from the income statement all special non-recurring or extraordinary gains, losses, and adjustments as being unrelated to a computation of normal periodic net income. This theory is subject to an important objection in that it subordinates income statement content to periodic net income computation. And as periodic net income, although computed often enough, has never been satisfactorily defined, computations of it vary with the individual accountant. Hence income statement content under this theory becomes a subjective matter varying with the individual's concept of net income.

The alternative view of the income statement is that it is a complete report on all operating activities aimed to provide adequate information to all legitimate interests in the corporation. This theory of the income statement holds that all operating information should be presented, properly classified, so that statement readers can select for themselves the material of interest and act accordingly. Proper content is not a matter of subjective opinion under this theory because all items of gain or loss are always included. This inclusive view of the income statement represents the original theory of an income statement as an account of all gains and losses now modified to meet the modern needs of income statement users.

Comparison of these two views, the "exclusionist" and "inclusionist" views respectively, finds that the inclusionist view is much to be preferred. It is objective in that it provides for including all gains and losses rather than only those which the individual accountant believes should be

included in a computation of net income; it is less open to manipulation, conscious or unconscious, because if all items must always be included the individual accountant cannot add special gains or exclude special losses at will; it is adapted to the current needs of statement readers because all interests in modern enterprise require complete operating information in order properly to perform their control function; and finally, it has a sound basis in the nature and function of accounting as a service device to provide adequate control information.

Various logical inferences can be drawn from this view of the income statement as an inclusive report made to certain interested parties. If carried to its logical conclusion it implies that the income statement should be a complete report upon all operating activities of the enterprise. It implies the inclusion of adequate detail to support summary figures. It implies the inclusion of information about income disposition as well as income acquisition. And finally it implies that all this information should be presented in such a way that it is understandable and useful to those who have need of it.

In order to test the conclusions reached by drawing the above inferences from an interpretation of the income statement as an inclusive report an inquiry was made into the needs of income statement readers as they have expressed themselves in current accounting literature. This survey of current literature resulted in unavoidable conclusions which served to corroborate the above inferences. Income statement readers require complete information about incomes, about costs, expenses, and other charges, about special items of gain and loss, about adjustments and corrections, and about the disposition of income as well as its acquisition. Specifically, this includes sales or other gross revenue, cost of sales in some detail, gross profit, expenses by classes, depreciation, income and other taxes, interest, and bad debts. Special gains or losses, dividends, additions to or reductions in surplus reserves, and the final change in surplus for the period should also be included. All of this information should

be classified, organized, and arranged to facilitate its use and comprehension.

Based upon the above conclusions a working definition of income statement content would be: all changes in amount or status of surplus net assets (i. e., the quantity obtained by subtracting liabilities plus capital stock from total assets). This definition is appropriate because (1) it recognizes the basic nature of business operations as consisting of dealings in assets; (2) it provides for an income statement which will meet the information needs of all interests in business enterprise; and (3) it thereby helps to fulfill the function of accounting as a service mechanism.

INCOME STATEMENT ORGANIZATION

A comparison of financial statements with statistical tables shows that financial statements have a responsibility to present data as usefully and helpfully as possible because frequently they stand alone as the accountant's only interpretive device. Interpretive presentation is largely a matter of organizing statements so that they will provide desired information quickly, understandably, and systematically. Form and organization should therefore be adapted to the needs of statement readers and to the nature of the material presented.

The purpose of interpretation in financial statements is to make them intelligible and interesting to alert readers, not to oversimplify business data to such an extent that anyone however uninformed of business complexities or careless in reading may seem to understand it completely. Neither is the purpose of interpretation to reach conclusions for the reader; it is to present as clearly and as usefully as possible information about asset acquisition, utilization, status, and disposition in order to provide control interests with a suitable basis for making informed decisions.

Interpretive presentation is obtained in the income statement by various means: textual comment is used both in footnotes and in the body of the statement to explain specific items; association and grouping of items is used to indicate

relationships existent in the data or to derive additional significant information; subdivision is employed to reveal distinctions; and order of presentation is used to obtain emphasis as well as to make association and subdivision possible.

Proper utilization of interpretive devices in income statement construction must rest upon a clear understanding of the characteristics and features of income statement data. To provide such an understanding the income statement data of a hypothetical company were classified according to their important characteristics. An appraisal of these several separations reached the conclusion that their relative usefulness to financial statement readers can be rated as follows:

I Essential:

1. Recurring and non-recurring.
2. Operating and non-operating.
3. Income-getting and income-distributing.

II Helpful:

1. Major, minor, and ancillary.
2. Earned and unearned (incomes).
3. Controllable and non-controllable (expenses).
4. Current and non-current.

III Of minor importance:

1. Fixed and variable (expenses).
2. Gross and net changes.
3. Contributing and non-contributing (expenses).

The similarities and differences indicated in these classifications provide the basis for systematic organization of income statement data.

Income statement organization should be undertaken with the function of financial statements as service mechanisms always in mind. Before interpretive devices are applied, the information wants and needs of statement readers should be determined. Those who read income statements do so in search of information which might help them to appraise the success or failure of operations and/or to determine whether the particular concern is or is not a good investment. The detailed information which is required before these

questions can be intelligently answered requires that the following associations of data be provided for:

- (1) Comparison of gross revenue with costs and expenses by activities to indicate success or failure of each activity.
- (2) Summation of net income from all activities to indicate over-all operating success or failure.
- (3) Grouping of all recurring distributions of income so that complete information about income distribution is available.
- (4) Comparison of total recurring net income and total recurring income disposition to determine if recurring income is adequate to meet all demands made upon it.
- (5) Grouping of all adjustments and corrections of income computations of prior periods together in order that none may be overlooked and so that their individual and combined importance can be ascertained.
- (6) Grouping of special or extraordinary items together so that none will be overlooked and so that their individual and combined significance can be ascertained.
- (7) Summation of all changes in surplus net assets to determine the net improvement or lack of improvement in over-all condition for the period as indicated by an increase or decrease in surplus net assets.

In addition to the relationships brought out by these associations, certain differences and distinctions which exist in the data must be revealed. This requires subdivision of the statement into groups and subgroups according to essential characteristics.

Sequence must be considered also in order that desired associations may be provided for and so that emphasis may be placed where most suitable.

The following outline portrays the sequence and subdivisions necessary and provides for all important associations. It is recommended as a basis for income statement construction.

I Recurring.

A. Income-getting.

1. Major activity.
 - a. Revenue.
 - b. Expenses (subdivided as desired).
2. Minor activity.
 - a. Revenue.
 - b. Expenses (subdivided as desired).
3. Ancillary activities.
- B. Income-distributing.
 1. Prior claims.
 2. Discretionary distributions.
- II Non-recurring.
 - A. Income-getting.
 1. Current.
 2. Non-current.
 - B. Income-distributing.

The essential separation of operating from non-operating data (according to general usage of those terms) is automatically provided for in this outline. Recurring income-getting items are operating; all others are non-operating.

Expenses of the various activities can be subdivided according to function, i. e., selling, administrative, etc., or upon the basis of fixed versus variable as appears most desirable.

STANDARDS FOR INCOME STATEMENT PRACTICE

The existence of widely varying practice regarding income statement form and content suggests that some means of eliminating unwarranted divergencies would be salutary. At various times in the past, model forms of financial statements have been proposed as a means of preventing excessive variations in accounting practice. At least two objections can be cited to oppose such model forms. First, it is difficult to provide in a model form for the variations which actually are required by the fact that statements must be prepared for diverse companies in various industries often under special circumstances. Secondly, it is difficult to be forward-looking or progressive with a model form. The tendency is rather to establish the *status quo* as

a criterion, thereby hindering rather than aiding progress.

Directive standards rather than model statements are needed to improve accounting practice. Used in this sense a standard is an ideal, a statement of the best practice set up to serve as a point of departure in case special circumstances require use of a treatment other than the standard. Standards are guides, not rules, an indication of what should be done if the highest type of practice is desired rather than a minimum requirement to satisfy the law or some other authority. A series of standards for income statement practice are set out below. They epitomize the conclusions of the thesis.

OPERATING STATEMENT STANDARDS

General

Financial statements are a service mechanism designed to convey needed information to various agencies invested with a power of control over business enterprise.

- I Data provided in financial statements should be factual, objective, and unbiased.
- II Presentation of data in financial statements should be designed to make them as understandable and useful as possible.
- III Financial statement data should be presented on a basis consistent both with the preceding and succeeding statements and consistent as to treatment of like items.
- IV Financial statement data should be presented so as to be as comparable as possible with similar data presented for similar concerns.

Content

Periodic operating statements should provide adequate information for all legitimate interests in business enterprise.

- I The operating statement should report all changes in the amount or status of surplus net assets, including:
 1. All incomes, expenses, gains, and losses.
 2. Adjustments of income computations of prior periods.
 3. Complete disposition of income.

4. Transfers to and from surplus reserves.
- II Adequate detail to serve reasonable needs of all legitimate interests should be included.
 1. Income and expense should be reported in sufficient detail to show the amounts applicable to each important class of operating activity.
 2. The share of each beneficial interest in income should be reported.
 3. The amount of any material gains, losses, or adjustments of income computations of prior periods should be reported individually.
 4. Adequate information should be reported to account for any material gain or loss which is the result of offsetting undisclosed cost (asset) and revenue (sales-price).

Organization

The operating statement should be organized and arranged in such a way as to impart as much intelligibility and usefulness to the data presented as possible.

- I All significant relationships existent in operating information should be revealed through proper association of data in the operating statement.
 1. Revenue and expense of the same activity should be offset against one another to determine net income of each activity.
 2. Recurring net income from every activity should be added to determine total recurring net income.
 3. Total recurring net income should be compared with recurring dispositions of net income.
 4. Current non-recurring gains and losses should be grouped together.
 5. Adjustments of income computations of prior periods should be grouped together.
- II Non-existent relationships or relationships which are not significant should not be suggested by association of data in the operating statement.
- III Subdivision should be employed wherever significant differences exist between two or more items and only where significant differences exist.
 1. Recurring items must be adequately distinguished from non-recurring items.
 2. Factors having to do with income disposition

- must be adequately distinguished from factors having to do with income determination.
3. Operating income and expense must be adequately distinguished from non-operating income and expense.
 4. Recurring income and expense should be subdivided by activities.
- IV Subdivision may be employed to derive significant figures not otherwise brought to light, providing that such subdivision does not indicate a difference not actually existent.
1. Expenses of each activity may be subdivided according to nature and function as desirable under the circumstances.
 2. Income dispositions may be subdivided as mandatory and discretionary.
- V Order or sequence of data should provide for proper associations and subdivisions of the material presented.
- VI Order of presentation may be used to indicate relative importance or to emphasize important items providing this does not eliminate essential association or subdivision.

Miscellaneous

Such other devices as may aid in presenting an intelligible and useful operating statement should be employed.

- I Textual comment and descriptive wording should be used wherever they can be of material assistance in giving intelligibility to operating statement information.
- II Misleading terminology should be avoided.
 1. "Gross profit on sales" is a misleading term and should not be used.
 2. "Net profit before depreciation" is a misleading term and should not be used.
- III Footnotes may be used when necessary but should be avoided if some other device such as explanation or comment in the body of the report can be effectively substituted.
- IV A "headline summary" to emphasize selected important items may be used, providing that all amounts included in it are also properly reported in an attached detailed statement.
- V A distinction between profit and loss account items and surplus account items may be added to the oper-

ating statement provided it does not interfere with other necessary associations and subdivisions.

It is believed that the above propositions provide for a high grade of income statement practice, that they are flexible and forward-looking. They are not to be considered as complete in themselves nor as rules for income statement construction. They merely provide a new approach to the principal problems of determining income statement content and arrangement. They are proposed as guides indicating what income statement practice should be in order that income statements may discharge fully their function as devices to furnish information to facilitate control over business enterprise.

VITA

Robert Kuhn Mautz was born in Fort William, Ontario, Canada, on April 12, 1915. He attended the grade schools of Grand Forks, North Dakota and was graduated from Grand Forks Central High School in 1933. He received the B.S. degree with honors in Accounting from the University of North Dakota in 1937, the M.S. degree from the University of Illinois in 1938, and the C.P.A. degree from the State of Illinois in 1940. He is a member of Beta Alpha Psi, Beta Gamma Sigma, and Phi Kappa Phi. He is author of an article entitled "Revising the 'Tentative Statement,'" published in *The Accounting Review* in March of 1941. He has been an assistant and instructor in Accountancy at the University of Illinois since September of 1937.

